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ARTICLES

REGULATING THE MUTUAL FUND INDUSTRY

Donna M. Nagy*

Today in the United States, nearly ninety-five million people, comprising more than half of all U.S. households, invest in mutual funds either directly or through retirement plans.¹ In April 2006, the total net assets of U.S. mutual funds hit a record high of nearly \$9.5 trillion, held in 8,008 separate funds.² By way of comparison, in 1980, there were combined assets of approximately \$135 billion in 564 funds.³ As these numbers reflect, the growth in the mutual fund industry over the last twenty-five years has been explosive.

The Securities and Exchange Commission (SEC), however, has not seen the budgetary increases that would have enabled it to stay in pace with the mutual fund industry. In the 1980s, the SEC sounded what became a perennial alarm as to its inability to keep up with industry growth and the consequent compromise to the effectiveness of its investment company inspection program.⁴ Self-regulation was proposed as a possible solution,

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1. See *Mutual Fund Trading Abuses: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 109th Cong. 6 (2005) [hereinafter *Trading Abuses Hearing*] (statement of Robert J. Hillman, Director, Financial Markets and Community Investment, U.S. Government Accountability Office).

2. Investment Company Institute, *Trends In Mutual Fund Investing*: April 2006 (May 30, 2006), http://www.ici.org/stats/mf/trends_04_06.html [hereinafter *Trends In Mutual Fund Investing*]. Mutual funds are by far the most common type of investment company, and large groups of mutual fund portfolios under the operation of a common investment adviser or sponsor are generally referred to as investment company or mutual fund “complexes.” The SEC oversees approximately 900 complexes. See *Trading Abuses Hearing*, *supra* note 1, at 37 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations).

3. *Mutual Fund Industry: Hearing Before the Subcomm. on Telecommunication and Finance of the H. Comm. on Energy and Commerce*, 103d Cong. 138 (1993) (statement of Arthur Levitt, SEC Chairman) [hereinafter *Mutual Fund Industry Hearing*]. In 1940, when the Investment Company Act and the Investment Advisers Act were enacted, there were a grand total of 68 mutual funds in operation. See WILLIAM J. BAUMOL ET AL., *THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION* 8 (1990).

4. See, e.g., McGrath Warns SEC May Use States, NASD to Oversee Advisers, *Due to Budget Woes*, 21 SEC. REG. & L. REP. (BNA) 449 (1989) (bemoaning the lack of funding and stating that investment companies and advisers “are being inspected less frequently” (quoting Kathryn McGrath, then director of the SEC’s Division of Investment Management)).

and from time to time throughout the next two decades, the SEC, Congress, and industry participants considered various proposals.⁵ Yet, for a variety of reasons—including the mutual fund industry’s relatively unblemished regulatory record and its claim to an extraordinarily high level of public confidence—none of these proposals resulted in the creation of a mutual fund self-regulatory organization (SRO).

Concerns about the adequacy of mutual fund oversight reached new heights in the wake of the market timing and late trading scandals first brought to public attention by New York State Attorney General Eliot Spitzer in 2003.⁶ Following closely on the heels of the Enron and WorldCom accounting scandals that gave rise to the creation of the Public Company Accounting Oversight Board (PCAOB), these mutual fund trading abuse scandals prompted renewed calls for restructured mutual fund regulation.⁷ And while proposals for statutory self-regulation modeled on the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) continue to be advanced for the mutual fund industry,⁸ even more attention is now being focused on the PCAOB’s model of “private” independent regulation.⁹

5. See *infra* Part I.B.

6. See Laura Johannes et al., *Fraud Charges Widen Scope of Scandal Facing Mutual Funds*, WALL ST. J., Dec. 12, 2003, at C1; Randall Smith & Tom Lauricella, *Spitzer Alleges Mutual Funds Allowed Fraudulent Trading*, WALL ST. J., Sept. 4, 2003, at A1; Deborah Solomon et al., *Milestone for ‘Timing’ Scandal*, WALL ST. J., Oct. 29, 2003, at C1 (providing a scandal “time line” that commences with Spitzer’s charges against Canary Capital on September 3, 2003). See also William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1403 (2006) (“Prior to Spitzer’s announcement, investment advisers . . . had enjoyed general approbation for the way in which they ran their businesses.”).

7. While the importance of the mutual fund trading abuse scandals, as well as the extent and effects of the wrongdoing, is certainly open to debate, see, e.g., Larry E. Ribstein, *Do the Mutuals Need More Law?*, 27 REG. 14 (2004); Henry G. Manne, *What Mutual Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22; see also Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC’s Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1274 (2006) (arguing that the SEC has “misunderstood the true nature of the scandal” and over-reacted to occurrences of frequent trading while under-reacting to the problem of fund arbitrage), few would dispute that the scandals provided advocates for change with a powerful rhetorical vehicle. Indeed, as Professor Jonathan Macey has observed, “public policy crises, whether real or imagined, provide an opportunity for entrepreneurial politicians and regulators to break the typical log-jams that make it more difficult to pass new rules during times of ordinary politics.” Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 118 (2005). Some of the calls for restructured mutual fund regulation were likely directed to this “policy window.” See *id.* at 137–38 (emphasizing “the need for federal officials to appear to be ‘doing something’ . . . in the wake of the scandals . . .” uncovered by Eliot Spitzer).

8. See Joel Seligman, *Should Investment Companies be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115, 1126 (2005) (“[A new SRO] could augment investment company boards, help investment companies themselves receive more rulemaking attention from the SEC, and, most significantly, help avoid the type of scandals that recently have besmirched the reputations of so many mutual fund families.”). See also American Enterprise Institute, *Former SEC Division Directors Give Their Views on Regulatory Reform* (Feb. 28, 2006), <http://www.aei.org/events/filter.all,eventID.1264/transcript.asp> (moderated roundtable

This article contends that while the regulatory regime for mutual funds could certainly be improved, the substitution of a private entity for the SEC as the industry's primary overseer is not the answer. Indeed, private regulation does not hold the solution for strengthening the oversight of mutual funds, whether along the lines of the PCAOB's model of independent regulation or the self-regulatory models of the NASD and NYSE. Rather, assuming that further study demonstrates the desirability of more frequent and/or more comprehensive inspections of mutual funds and their advisers, Congress should infuse the SEC with the resources necessary to accomplish that end. This undertaking could be funded through any number of avenues.

This article proceeds in three parts. Part I provides a brief overview of the mutual fund industry and its regulatory landscape. Part II focuses on private regulation and concludes that neither the PCAOB's model of independent regulation nor the NASD and NYSE's model of self-regulation is appropriate for the mutual fund industry. Part III explores how to improve the regulatory regime for the mutual fund industry and advances a number of suggestions.

I. THE MUTUAL FUND INDUSTRY AND ITS REGULATORY LANDSCAPE

A. THE CURRENT REGIME

The mutual fund industry continues to thrive despite the bevy of scandals revealed to the investing public in 2003 and 2004, at least by the measures of total assets under management (\$9.485 trillion as of April 2006) and new dollars invested (more than \$500 billion in the first four

featuring four former directors of the SEC's Division of Investment Management). Among other questions, the following was posed at the beginning of the program: "Should there be a self-regulatory organization for mutual funds [modeled on] . . . the NASD, and if so, what functions should it perform?" *Id.* at 1–2. For the view that an SRO for mutual funds "would substitute a weaker enforcement regime by an SRO for a stronger regime by the SEC," see Tamar Frankel, *Should Funds and Investment Advisers Establish a Self-Regulatory Organization?*, in *THE FINANCIAL SERVICES REVOLUTION, UNDERSTANDING THE CHANGING ROLES OF BANKS, MUTUAL FUNDS AND INSURANCE COMPANIES* 447, 453 (Clifford E. Kirsch ed., 1997).

9. See, e.g., Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201, 149 CONG. REC. 15,977, 15,984 (2003) (introducing legislation from Senators Thomas Daschle, Edward Kennedy, and John Kerry that, among other things, would have established a "Mutual Fund Oversight Board" modeled after the PCAOB); *Mutual Funds: Who's Looking Out for Investors? Hearings Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H.R. Comm. on Financial Services*, 108th Cong. 157–58 (2003) [hereinafter *Looking Out for Investors Hearing*] (statement of Professor Mercer Bullard) (recommending that Congress create a Mutual Fund Oversight Board). *But see* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1069–71 (2005) (arguing that Congress should resist the temptation to replicate the PCAOB model in other areas, including the mutual fund industry).

months of 2006).¹⁰ Although late trading and market timing scandals captured the lion's share of publicity, many other illegal practices were unearthed during this time period including those involving unpaid breakpoint discounts,¹¹ mispriced assets,¹² and undisclosed revenue-sharing with broker-dealers.¹³

The response to the mutual fund scandals at the federal level was swift.¹⁴ Although political pundits predicted the passage of mutual fund legislation in the wake of the scandals, Congress opted instead for a "wait and see" approach to evaluate the results of the SEC's unprecedented efforts toward industry reform.¹⁵ Accordingly, proposals for private sector regulation of the mutual fund industry must be assessed in light of the regulatory regime described below.

1. The Statutory Framework

Mutual funds are regulated under each of the four principal securities laws: the Securities Act of 1933 (the Securities Act),¹⁶ the Securities Exchange Act of 1934 (the Exchange Act),¹⁷ the Investment Advisers Act

10. See *Trends in Mutual Fund Investing*, *supra* note 2, at 1. However, empirical research shows that the market timing and late trading scandals affected investor behavior: investors penalized both the funds that were involved in the scandals, and to a lesser extent the fund complexes, "by making statistically and economically significant withdrawals." Stephen J. Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals* 1 (N.Y.U. Law Sch. Law & Econ. Research Paper Series, Working Paper No. 06-07), available at <http://ssrn.com/abstract=877896>.

11. *Broker-Dealers: 15 Firms to Pay \$21.5M, Resolving SEC, NASD Charges over Breakpoints*, 36 SEC. REG. & L. REP. (BNA) 329, 329 (Feb. 23, 2004).

12. See Rachel McTague, *Mutual Funds: SEC Inspections Staff Refers Fund Cases Involving Fair Value Pricing to Enforcement*, 36 SEC. REG. & L. REP. (BNA) 801 (May 3, 2004); Press Release, Sec. Exch. Comm'n, SEC Levels Fraud Charges Against Heartland Advisors, Inc., 12 Company Officials and Others for Misrepresentations, Mispricing and Insider Trading in Two High Yield Bond Funds (Dec. 11, 2003), available at <http://www.sec.gov/news/press/2003-171.htm>.

13. See Rachel McTague, *Mutual Funds: SEC Enforcement Energy Goes into Probes of Broker-Dealers', Funds' Revenue-Sharing*, 36 SEC. REG. & L. REP. (BNA) 97 (Jan. 19, 2004); Richard Hill, *Mutual Funds: NASD Running 'Sweep' Into Fund Payments to B-DS; Dems. Agree to Change Funds Bill*, 35 SEC. REG. & L. REP. (BNA) 1918 (Nov. 17, 2003).

14. See Brooke Masters, *A Year of Charges, Reforms for Funds: Regulators Imposed Fines, Crafted New Rules*, WASH. POST, Sept. 1, 2004, at E1.

15. See Rachel McTague, *Mutual Funds: Donaldson, Shelby on Same Wave Length: SEC Able to Handle Mutual Fund Reforms*, 36 SEC. REG. & L. REP. (BNA) 661 (Apr. 12, 2004) (quoting Senate Banking Chairman Richard Shelby's statement that the SEC is "showing a lot of leadership and resolve. . . . We don't want to do anything that would be construed in any way as undermining what the SEC is doing.").

16. See generally Securities Act of 1933, ch. 38, 48 stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77bbbb) (providing that all public offerings of securities, including shares sold by mutual funds, must adhere to the registration provisions in Section 5 of the Securities Act).

17. See generally Securities Exchange Act of 1934, ch. 404, 48 stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78mm) (providing broad anti-fraud provisions and regulating the broker-dealers and underwriters involved with the distribution and sale of mutual fund shares).

of 1940 (the Advisers Act),¹⁸ and the Investment Company Act of 1940 (the ‘40 Act).¹⁹ Often described as the most complex of these laws,²⁰ the ‘40 Act was enacted specifically to regulate mutual funds and other types of investment companies as well as the investment advisers who manage them.²¹

The statutory scheme in the ‘40 Act requires mutual funds to register with the SEC,²² mandates extensive disclosure,²³ and, because disclosure alone was viewed as insufficiently protective of shareholder interests,²⁴ imposes a vast array of highly specific substantive requirements and prohibitions. These requirements and prohibitions include those that relate to mutual funds and their capital structure,²⁵ the composition and structure of their boards of directors,²⁶ the types of transactions in which they can engage (including a near outright ban on transactions with affiliates),²⁷ and the diversification of their investments among different industries.²⁸ However, to mitigate some of the harshness of these provisions, the ‘40 Act gave the SEC broad authority to exempt investment companies and advisers—conditionally or unconditionally—from virtually any statutory requirement or prohibition.²⁹ The ‘40 Act also gave the SEC broad authority to issue rules imposing additional regulatory requirements.³⁰

18. See generally Investment Advisers Act of 1940, ch. 686, 54 stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (2000)) (requiring registration of all investment advisers to mutual funds (except banks, which are regulated separately), imposing recordkeeping, reporting, and disclosure requirements, containing broad anti-fraud provisions, and imposing on investment advisers a general fiduciary duty to the clients they serve).

19. See generally Investment Company Act of 1940, ch. 686, 54 stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2000)).

20. See LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 262–64 (3d ed. 1998) (attributing the ‘40 Act’s complexity to the “different types of companies it covers and the intricacies of the problems it presents”). Professor Jerry Markham accords the 1940 Act an even more dubious distinction, rendering it the “world’s most complex statute.” Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT’L L. 319, 326 n.34 (2003).

21. See *supra* note 19.

22. 15 U.S.C. § 80a-7 (2000) (providing that unless it is registered with the SEC pursuant to Section 8 of the ‘40 Act, an investment company may not engage in any business in interstate commerce or use the mails or other instrumentalities of interstate commerce to offer for sale any security).

23. *Id.* § 80a-29 (requiring periodic reports to be filed with the SEC and disseminated to shareholders).

24. See TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 1.02[B][2][b] (2d ed. 2006 Supp.) (“In many respects, investment companies are like banks, insurance companies and pension funds, all of which are regulated not only by disclosure but also by substantive regulation.”).

25. 15 U.S.C. § 80a-18(i) (2000).

26. *Id.* § 80a-10 (2000).

27. *Id.* § 80a-17(a), (d), (e) (2000).

28. *Id.* § 80a-12 (2000).

29. *Id.* § 80a-6(c) (2000). A leading treatise notes that the SEC’s broad exemptive powers “allowed the SEC to impose conditions that became the new set of rules for the industry” and that “[t]his method allowed for an adjustment of the Act piecemeal by orders, and then by Rules,

As Congress envisioned, the SEC's role in regulating mutual funds is substantial. In addition to its broad exemptive and rulemaking authority, the SEC has the responsibility of ensuring compliance with the '40 Act's provisions and the rules and regulations promulgated thereunder. In furtherance of this end, the SEC's Office of Compliance Inspections and Examinations (OCIE) conducts periodic inspections of mutual funds and their investment advisers.³¹ When these inspections reveal serious regulatory violations, or when regulatory violations are otherwise suspected, the Division of Enforcement can initiate investigations.³² If warranted, the Division may seek Commission authorization for the initiation of enforcement actions which may be brought in federal court or in administrative proceedings.³³

As the principal regulator for broker-dealers, the NASD also plays a limited role in mutual fund regulation. Specifically, broker-dealers who sell mutual funds must comply with NASD rules pertaining to sales practices and advertising, and are subject to periodic examinations and inspections by the NASD staff. Broker-dealers who violate these rules or the federal securities laws are subject to discipline by the NASD.

The statutory framework further places considerable supervisory responsibilities on a mutual fund's board of directors, particularly independent (or disinterested) directors.³⁴ Among other responsibilities, directors are charged with initial approval and periodic review of the mutual fund's investment advisory and distribution contracts (including the fees charged for these services).³⁵ These contracts must be reviewed annually and must be approved by a majority of the fund's independent directors.

Federal courts are, of course, the ultimate arbiter of whether mutual funds, and those who direct and advise them, have complied with their statutory obligations. In addition to statutory provisions that authorize both

without resort to legislation." FRANKEL & SCHWING, *supra* note 24, § 1.02[B][2]. However, it goes on to note that approximately every ten years, Congress reviews the Act and "in most cases, codif[ies] the SEC's exemptive rules, sometimes with changes." *Id.*

30. 15 U.S.C. § 80a-38 (2000).

31. Investment companies and investment advisers are required to maintain records for examination by the SEC. *See id.* § 80a-30 (2000).

32. The Enforcement Division may initiate informal investigations on its own accord. But formal investigations, pursuant to which enforcement staff may subpoena documents and testimony, may only be initiated with approval by the Commission. 17 C.F.R. § 202.5(a) (2006).

33. 15 U.S.C. § 80a-41(d) (Supp. II 2002) (injunctive actions); 15 U.S.C.A. § 80a-9(f) (West 2006) (cease and desist orders).

34. *See* Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility: What Regulation By the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 915 (2005) (noting that Congress structured the Investment Company Act in a way that positioned "the disinterested directors in the role of watchdogs to act as an independent check on the management of the investment company").

35. 15 U.S.C. § 80a-15 (2000).

criminal³⁶ and civil monetary penalties,³⁷ the '40 Act provides an express private right of action for breaches of fiduciary duty involving compensation and fees paid by mutual funds to their advisers or affiliated persons.³⁸ Although courts traditionally recognized implied rights of action under various statutory provisions, a number of recent decisions have held that the '40 Act does not give rise to causes of action that are merely implied from the statutory text.³⁹

2. Recent Regulatory Reforms

That the mutual fund scandals were first unearthed by the New York State Attorney General's Office and not the SEC, the agency principally charged with enforcing the federal securities laws, gave the SEC much to answer for.⁴⁰ The question "where was the SEC?" was posed repeatedly by members of Congress,⁴¹ in newspaper editorials,⁴² and in scholarly com-

36. See *id.* § 80a-48 (2000) (stating that willful violations of the '40 Act are punishable by fines and up to five years in prison).

37. *Id.* § 80a-41.

38. *Id.* § 80a-36(b).

39. See Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1025 (2005) (discussing several implied rights of action, but noting the recent "lively debate" over whether any private rights of action should be implied under the 1940 Act). See also William K. Sjostrom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251, 262 (2005) (discussing implied rights of action under the 1940 Act).

40. Based on a survey sent to mutual fund complexes shortly after Spitzer's revelations, the SEC estimated that approximately half of the eighty-eight largest mutual funds had undisclosed arrangements with favored clients that allowed these shareholders to engage in market timing that contravened publicly stated policies regarding short term trading. See *Looking Out for Investors Hearing*, *supra* note 9, at 11–12 (testimony of Stephen Cutler, Director, SEC Division of Enforcement). Surveys to the 34 largest broker-dealers revealed that more than 25% permitted certain customers to place or confirm orders after 4:00 p.m. and receive the 4:00 p.m. net asset value (NAV) price. *Id.*

41. See Stephen Labaton, *Extensive Flaws at Mutual Funds Cited at Hearing*, N.Y. TIMES, Nov. 4, 2003, at A1 (highlighting bipartisan criticism of the SEC's failure to detect mutual fund trading abuses).

42. See, e.g., Steve Bailey, Op-Ed., *Asleep at the Switch*, B. GLOBE, Oct. 24, 2003, at D1.

As the scandals roll out across Wall Street and beyond . . . the question "Where was the Securities and Exchange Commission?" is becoming part of the lexicon. . . . It has been left to New York Attorney General Eliot Spitzer to uncover one problem after another in the securities business and to show the SEC and its boss, William Donaldson, what regulation is all about.

Id. See also Editorial, *Eliot Spitzer, Once Again*, BUS. WK., Sept. 15, 2003, at 120.

Where is the [SEC] in this reform effort? . . . Why did it leave it to a state AG to oversee the mutual-fund industry, just as it did with Wall Street research? . . . If Washington doesn't want 50 Eliot Spitzers making policy, it had better make sure the SEC and Justice do their jobs.

Id.

mentary.⁴³ The question was also the principal focus of a report to Congress prepared by the Government Accountability Office (GAO).⁴⁴ Not surprisingly, the SEC's failure to detect the mutual fund trading abuses has been attributed to a variety of factors, including inadequate resources and inaccurate risk assessment by SEC staff, the latter due in part to the staff's mistaken belief that mutual fund complexes were being vigilant in self-policing frequent trading.⁴⁵ Others have argued that the SEC, and more particularly its Division of Investment Management, fell prey to the problem of agency capture.⁴⁶

Yet even the SEC's critics would likely acknowledge that the SEC placed a high priority on reform once it was alerted to the extent of the trading abuses in the mutual fund industry.⁴⁷ Specifically, the SEC responded to the scandals with aggressive rulemaking, stepped-up enforcement actions, and a revamped mutual fund inspection program that revised examination techniques and significantly expanded the number of examiners. The following sub-sections briefly explore each of these regulatory reforms.

43. John C. Coffee, Jr., *A Course of Inaction: Where was the SEC When the Mutual Fund Scandal Happened?*, LEGAL AFF., March/April 2004, at 46, available at http://www.legalaffairs.org/issues/March-April-2004/review_coffee_marapr04.msp. See also Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 177-78 (2004) (raising important policy questions, including "why didn't the Securities and Exchange Commission discover the late trading and market timing abuses until they had apparently become widespread?").

44. See U.S. GOV'T ACCOUNTABILITY OFFICE, MUTUAL FUND TRADING ABUSES: LESSONS CAN BE LEARNED FROM SEC NOT HAVING DETECTED VIOLATIONS AT AN EARLIER STAGE, REP. NO. GAO-05-313 (Apr. 2005), available at <http://www.gao.gov/new.items/d05313.pdf> [hereinafter *GAO Lessons Learned Report*].

45. See *id.* at 11-12. (recognizing that the SEC faced "competing examination priorities and had limited examination resources prior to September 2003" and noting that the SEC staff viewed fund complexes as having "financial incentives to control frequent trading").

46. See *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Financial Management, the Budget, and Int'l Security Subcomm. of the Comm. on Gov. Affairs*, 108th Cong. 268 (2004) (statement of Professor John P. Freeman) (arguing that the SEC's Division of Investment Management "has become far too deferential to the industry" and thus "presents a classic case of 'regulatory capture'"). See also Coffee, *supra* note 43, at 46 ("[A]dopting a profile of being tougher than the SEC may further Spitzer's political ambitions, but this does not mean that he is wrong to suggest that the SEC has been too soft—that it has, to a degree, been 'captured' by the politically powerful mutual fund industry."); Macey, *supra* note 7, at 117-18 ("The SEC's passivity" in areas including mutual fund regulation "was likely caused by the agency's capture by the same special interests it was ostensibly regulating.").

47. Some might contend that the principal impetus for reform was a need on the part of SEC officials to restore the agency's reputation as an effective regulator. See Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 967 (2005) ("It is hardly likely that the SEC's neglect of the problems in the mutual fund industry would have ended so suddenly without the pressure exerted by the New York Attorney General's interest in the issue.").

a. Mutual Fund Rulemaking

Mutual fund initiatives were much on the minds of SEC officials after the burst of the so-called high-tech bubble and the collapses of Enron and WorldCom.⁴⁸ But the pace of the SEC's rulemaking agenda quickened substantially in the months following the public revelation of the late trading and market timing scandals.

A principal component of the SEC's rulemaking agenda involved the tightening of internal controls and operations of mutual funds. Pursuant to these new rules, investment companies and investment advisers registered with the SEC are required to implement, review, and maintain "written compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations."⁴⁹ Mutual funds and their advisers must also designate a chief compliance officer (CCO) who is responsible for monitoring both the entity's compliance with laws and regulations and the entity's own written policies and procedures.⁵⁰ In addition, registered investment advisers must adopt written codes of ethics, a mandate previously applicable only to investment companies.⁵¹

Other new rules were designed to enhance the governance structure of mutual funds. The most important (and most controversial) of these governance rules required that in order for a mutual fund to avail itself of certain SEC exemptions, the chairman of its board of directors and at least seventy-five percent of the board itself must be independent from the fund's investment adviser.⁵² The new governance rules also condition exemptions on the

48. See *infra* notes 86–90 and accompanying text (discussing the SEC's release on investment company compliance programs, issued more than six months before the mutual fund scandals).

49. *Trading Abuses Hearing*, *supra* note 1, at 46 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations); Investment Company Act Rule 38a-1(a)(1), 17 C.F.R. § 270.38a-1(a)(1) (2006). See also Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714 (Dec. 24, 2003). The rules were effective as of Feb. 4, 2004, with a delayed compliance date of Oct. 5, 2004. *Id.*

50. Investment Company Act Rule 38a-1(a)(4), 17 C.F.R. § 270.38a-1(a)(4), (e) (2006).

51. See *id.* § 270.17j-1(c)(1)(i) (2006); Investment Adviser Code of Ethics, Investment Company Act Release No. 2256, 83 SEC Docket 828 (July 2, 2004). Among other things, a code of ethics must set forth the standards of business conduct expected of supervisory personnel, 17 C.F.R. § 275.204A-1(a)(1) (2006), and must require "access persons" to report to the adviser their personal securities transactions, including transactions in any mutual fund managed by the adviser. *Id.* § 275.204A-1(b).

52. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,380–81 (Aug. 2, 2004). As of July 2006, both the 75% independent directors condition and the independent chairperson condition are in legal limbo. Both conditions were adopted by a sharply divided Commission (3–2) and were promptly challenged in a lawsuit filed by the U.S. Chamber of Commerce. On two separate occasions, the D.C. Circuit ruled in favor of the plaintiffs. In its first ruling, the D.C. Circuit remanded the rule to the SEC, concluding that the SEC had violated the Administrative Procedures Act (APA) by failing to determine the costs of these two conditions and by failing to address a proposed alternative to the independent chairperson condition. See *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 137, 143–45 (D.C. Cir. 2005). The SEC responded by reconsidering the conditions

requirements that independent directors hold quarterly “executive sessions” separate from the board and that they have the authority to hire staff (including independent counsel) to support their oversight responsibilities.⁵³

The SEC also proposed rules to address the specific problems of market timing and late trading. One proposed rule would have imposed a mandatory two percent redemption fee on fund shares sales made within five days of a purchase.⁵⁴ However, in response to comments from the industry, the SEC ultimately adopted a modified rule that allows—but does not require—funds to impose such fees.⁵⁵ To thwart the illegal practice of late trading, the SEC proposed a rule that would require all orders for purchases or sales of fund shares to be received at the fund by a 4 p.m. EST “hard close.”⁵⁶ Opposition to this proposed rule has been intense, however, and the SEC appears to be considering alternatives.⁵⁷

A final set of rules are aimed at enhancing the disclosures made by mutual funds to the investing public. Pursuant to these requirements, mutual funds must disclose their policies and procedures with respect to (1) market timing, (2) “fair valuation” of their portfolio holdings, and (3) disclosure of their portfolio holdings.⁵⁸ The new rules also significantly expanded the information required to be disclosed periodically to mutual fund

based on the original record, and readopting those conditions by the same sharply divided 3–2 vote (on virtually the eve of Chairman William Donaldson’s retirement from the Commission, no less). The Chamber of Commerce quickly launched a second challenge, and on April 7, 2006, the same panel of the D.C. Circuit vacated both conditions, concluding that the SEC’s speedy “reconsideration” had violated the APA by failing to afford the opportunity for public comment on certain data the Commissioners used in estimating the costs of complying with the two conditions. *See* Chamber of Commerce v. Securities and Exchange Commission, 443 F.3d 890, 899–908 (D.C. Cir. 2006). In response to the D.C. Circuit’s ruling, the SEC has sought additional comments from the public on both the 75% independent directors condition and the independent chairperson condition, and has asked specifically for comment on the costs of complying with these conditions and whether these conditions “will promote efficiency, competition, and capital formation” as required by Section 2(a) of the 1940 Act. *See* Investment Company Governance, Request for Additional Comment, Investment Company Act Release No. 27395, 71 Fed. Reg. 35,366 (June 19, 2006).

53. Investment Company Governance, 69 Fed. Reg. at 46,384–85.

54. Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375, 69 Fed. Reg. 11,762 (Mar. 11, 2004).

55. Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328 (Mar. 18, 2005).

56. Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388 (Dec. 17, 2003).

57. *See Mutual Funds: A Review of the Regulatory Landscape, Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 61 (2005) (statement of Meyer Eisenberg, Dir., SEC Div. Inv. Mgt.).

58. *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 23, 2004).

shareholders.⁵⁹ In addition, mutual funds are now required to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads.⁶⁰

b. Enforcement Actions Against Mutual Funds

The SEC wasted no time stepping up its own enforcement efforts in response to Eliot Spitzer's widely publicized charges of fraud in the mutual fund industry.⁶¹ As the Director of the SEC's Enforcement Division reported to Congress, "immediately following [Spitzer's] announcement, relying on the Commission's examination powers, the Commission's staff sent detailed information requests to 88 of the largest mutual fund complexes in the country and 34 broker dealers . . . [seeking] information on each entity's policies and practices relating to market timing and late trading."⁶² Many of the responses "warranted aggressive follow-up" inspections by SEC examiners and others "led to referrals to the enforcement staff for further investigation."⁶³ Additional investigations were launched based on evidence uncovered through the efforts of both the SEC's enforcement staff and state attorneys general, particularly Spitzer.⁶⁴

As of May 2005, the SEC had initiated 29 enforcement actions involving fund complexes and their employees (including many of the nation's largest complexes) and 12 enforcement actions involving broker-dealers and their employees.⁶⁵ Through settlements with these firms and actions filed subsequently, the SEC has collected more than \$3.3 billion dollars in penalties and disgorgement.⁶⁶ The SEC intends to distribute this

59. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,485, 69 Fed. Reg. 39,798 (June 30, 2004).

60. Disclosure of Breakpoint Discounts by Mutual Funds, Securities Act Release No. 8427, Exchange Act Release No. 49,817, Investment Company Act Release No. 26,464, 69 Fed. Reg. 33,262 (June 14, 2004).

61. For the first of many press releases from the N.Y. State Attorney General's Office on the mutual fund scandals, see Press Release, Office of N.Y. State Attorney General Eliot Spitzer, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. The press release announced a \$40 million dollar settlement with hedge-fund Canary Investment Management LLC for engaging in the practices of late trading and market timing in several mutual fund complexes. Spitzer's complaint against Canary named four companies that had permitted such trading: Bank of America Corp., Bank One Corp., Strong Capital Management, and Janus Capital Corp. *Id.*

62. *Looking Out for Investors Hearing*, *supra* note 9, at 184–85 (statement of Stephen Cutler, Director, SEC Division of Enforcement).

63. *Id.* at 185.

64. *Id.* at 180 (describing SEC enforcement efforts relating to mutual fund trading and stating that "we are working aggressively . . . in close connection with State regulators, including Mr. Spitzer and Mr. Galvin in Massachusetts").

65. See *Trading Abuses Hearings*, *supra* note 1, at 38 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations).

66. See Annette L. Nazareth, Sec. Exch. Comm'n, Commissioner, Remarks before the ABA National Institute on Securities Fraud (Sept. 28, 2006), *available at* <http://www.sec.gov/news/>

settlement money to mutual fund shareholders who had been harmed by the trading abuses.⁶⁷ In addition to substantial monetary payments and prophylactic relief in the form of cease-and-desist orders or injunctions, the SEC settlements contained undertakings that required the firms to improve their compliance practices and corporate governance structure.⁶⁸

c. Mutual Fund Inspections and Examinations

Approximately 500 examiners are currently assigned by the OCIE to inspect investment companies and investment advisers.⁶⁹ Prior to the mutual fund scandals, the SEC had fewer than 360 examiners.⁷⁰ Even before the scandals broke, a significant number of new hires had been planned from the substantial appropriation increases to the SEC's budget as part of the Sarbanes-Oxley Act of 2002.⁷¹ But the scandals reemphasized the priority of enhancing the oversight of mutual funds.

The addition of these new examiners enabled the OCIE to increase the frequency of its examinations: the nation's largest funds are now scheduled for examination at least once every two to three years.⁷² From 1998-2003, the OCIE examined these firms once every five years, and prior to 1998 the cycles for examination had been the remarkably long length of once every 12 to 24 years.⁷³

speech/2006/spch092806aln.htm [hereinafter Nazareth Remarks]. By way of example, the SEC's case against Bank of America resulted in the payment of \$250 million in disgorgement and a civil penalty of \$125 million. *See* Press Release, Sec. Exch. Comm'n, SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading: Bank of America to Pay \$375 Million, Exit Mutual Fund Clearing Business, and Make Other Remedial Reforms (Mar. 15, 2004), *available at* <http://www.sec.gov/news/press/2004-33.htm>. Alliance Capital Management agreed to pay \$150 million in disgorgement and a civil penalty of \$100 million. *See* Press Release, Sec. Exch. Comm'n, Alliance Capital Management Will Pay Record \$250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges: Entire Amount Will Be Returned To Investors Who Lost Money Because of Firm's Illegal Timing Arrangements (Dec. 18, 2003), *available at* <http://www.sec.gov/news/press/2003-176.htm>. Putnam agreed to pay \$5 million in disgorgement and \$50 million in civil penalties. *See* Press Release, Sec. Exch. Comm'n, Putnam Agrees to Pay \$55 Million to Resolve SEC Enforcement Action Related to Market Timing by Portfolio Managers, S.E.C. 04-49, 2004 WL 762426 (Apr. 8, 2004). And for its role in facilitating late trading and market timing of mutual funds by its customers and the customers of its introducing brokers, Bear Stearns recently consented to a payment of \$160 million in disgorgement and \$90 million in civil penalties. *See* Press Release, SEC Settles Fraud Charges with Bear Stearns for Late Trading and Market Timing Violations: Firm to Pay \$250 Million in Disgorgement and Penalties (Mar. 16, 2006), *available at* <http://www.sec.gov/news/press/2006-38.htm>.

67. *See* Nazareth Remarks, *supra* note 66.

68. *See* GAO *Lessons Learned Report*, *supra* note 44, at 25.

69. *See* *Trading Abuses Hearing*, *supra* note 1, at 37 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations).

70. *Id.*

71. *Id.* ("[B]udget increases allowed the SEC to increase its staff for fund examinations by a third . . .").

72. *Id.* at 42.

73. *Id.*

The OCIE has also substantially revised its examination techniques to improve the staff's ability to more promptly identify emerging compliance problems.⁷⁴ Specifically, the OCIE has shifted to a "risk-based" methodology for examining mutual funds and investment advisers which "allows the staff to move more quickly, to be more nimble, and to be more responsive to the rapidly changing risk environment in the fund community."⁷⁵ This new risk-based approach focuses routine examinations on the nation's largest funds and other firms posing the greatest compliance risks (approximately 200 fund groups and 600 advisers).⁷⁶ The remaining firms are examined "for cause" in sweeps directed at specific risks or possible violations across numerous firms, or at random.⁷⁷

The OCIE's new methodology is also credited with making greater use of technology and data and increasing the number of interviews during examinations in order to better assess a firm's control or risk environment.⁷⁸ Other enhancements include the establishment of "monitoring teams" for the largest fund complexes, which allow examiners to become better acquainted with the business and operations of a specific complex. In addition, OCIE staff examiners work closely with the SEC's new Office of Risk Assessment "to help identify and coordinate areas of risk across the agency."⁷⁹

B. PERIODIC CALLS FOR PRIVATE SECTOR REGULATION

From time to time over many decades, the SEC, Congress, and the industry itself has considered the possibility of utilizing private sector regulation for mutual funds and/or investment advisers. This section briefly

74. See *id.* at 41–46. See also *GAO Lessons Learned Report*, *supra* note 44, at 21 ("Over the past 2 years, SEC staff has taken steps to better detect abusive practices in the mutual fund industry and plans significant changes to its overall examination program.").

75. See *Trading Abuses Hearing*, *supra* note 1, at 41 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations).

76. See *GAO Lessons Learned Report*, *supra* note 44, at 23.

77. *Id.* ("[Examiners will] conduct random inspections of some portion of the remaining firms.").

78. See *Trading Abuses Hearing*, *supra* note 1, at 42 (prepared statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations). See also *GAO Lessons Learned Report*, *supra* note 44, at 22 (reporting the OCIE Director's statement that "interviews had begun to play an increased role in assessing companies' critical risks and control environments").

79. *Trading Abuses Hearing*, *supra* note 1, at 42 (statement of Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations). As described in the GAO report, the duties of the Office of Risk Assessment include:

- (1) gathering and maintaining data on new trends and risks from external experts, domestic and foreign agencies, surveys, focus groups, and other market data;
- (2) analyzing data to identify and assess new areas of concern across professions, companies, industries, and markets; and
- (3) preparing assessments and forecasts on the agency's risk environment.

GAO Lessons Learned Report, *supra* note 44, at 24.

examines several proposals relating specifically to the mutual fund industry and explores some of the reasons why these proposals have not resulted in private regulation.

1. Proposals from the SEC

While informal discussions between SEC officials and industry participants about private regulation for mutual funds are legion,⁸⁰ only twice—in 1983⁸¹ and 2003⁸²—has the SEC sought public comment on a specific proposal for a mutual fund SRO.⁸³ On both occasions the industry

80. As far back as the early 1960s, the SEC had begun urging the Investment Company Institute to establish itself a self-regulatory organization for mutual funds. *See* William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 247 (1963) (“[The SEC and the ICI both] agreed on the principle that more inspection of investment companies is called for,” but the “industry believed [that the SEC] should perform the inspection,” whereas the SEC “suggested that the Institute take the initiative.”). These informal discussions between the SEC and the ICI intensified again in the early 1980s. *See Will ICI Lend SEC a Hand in Watching Over Industry*, FUND ACTION, Feb. 7, 2005, at 1 (“When David Ruder was SEC Chairman . . . we came very close to making ICI the SRO for funds.” (quoting former ICI President David Silver)). According to Silver, it floundered on only one point: the “ICI wanted an assurance the SEC would not give that if the Institute took an enforcement action against a fund company the SEC, NASD or the states would not jump in with actions of their own.” *Id.*

81. *See Utilizing Private Entities*, Investment Company Act Release No. 13,044, 68 Fed. Reg. 7038 (Feb. 23, 1983).

82. *See Compliance Programs*, Investment Company Act Release No. 25,925, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,827, at 87,177 (Feb. 5, 2003).

83. On several occasions during the 20 year period between these proposals, SEC officials raised in congressional testimony the possibility of an SRO for funds and/or advisers. *See Hearings on the Unfair Practice that Exists with Some Financial Planners and the Need for Congress to Support the SEC Through Additional Funding and Staffing for Regulation of the Financial Planning Industry: Hearing Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 26 (1992) (testimony of Richard C. Breeden, SEC Chairman):

Another proposal that has been made in the past would be to create an SRO in this area. That’s certainly a possibility. When the Commission proposed that a couple of years ago, there was a great deal of objection received from a number of groups in the public, and frankly, we believe it would be much more expensive than conducting examinations through the SEC.

Id. Proposed Amendments to the Investment Advisers Act of 1940: Hearings Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce, 102d Cong. 127 (1992) (testimony of Richard C. Breeden, SEC Chairman) (“I would agree that, in concept, [an SRO] is something worth looking at In fact it might be considerably more costly than an SEC examination. . . . We would be happy to work with the SRO’s in areas where it made sense, and from an overall point of view of economy.”). *See also Oversight Hearing on the Mutual Fund Industry: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong. 12 (1993) [hereinafter *Oversight Hearing on the Mutual Fund Industry*] (testimony of Arthur J. Levitt, SEC Chairman):

I think, in general, an SRO has proven to be one of the most effective ways of monitoring a growing complex of financial services in our society, and it’s a way that I am seriously considering with respect to investment companies and even considering more seriously with respect to investment advisers.

reaction was exceedingly negative.⁸⁴ Indeed, unlike the broker-dealer industry which historically has embraced self-regulation, the mutual fund industry has been quite content with direct regulation and examination by the SEC.⁸⁵

The SEC's 2003 proposal was significantly broader than the "inspection-only" proposal floated twenty years earlier. Couched in the Release as one of four potential approaches to increasing private sector involvement in the SEC's regulatory program, the 2003 proposal noted that an SRO for mutual funds:

would function in a manner analogous to the national securities exchanges and registered securities associations under the Securities Exchange Act of 1934 by (i) establishing business practice rules and ethical standards, (ii) conducting routine examinations, (iii) requiring minimum education or experience standards, and (iv) bringing its own actions to discipline members for violating its rules and the federal securities laws.⁸⁶

As with the NASD and the NYSE, any SRO for mutual funds "would be subject to the pervasive oversight of the Commission" and the SEC "would examine its activities, require it to keep records, and approve its rules. . . ."⁸⁷ But the Release further stated that the "staff would continue to examine the activities of funds and advisers, both to ensure adequate examination coverage and to provide oversight of the SRO examination program."⁸⁸

Id.

84. See *infra* notes 91–95 and accompanying text.

85. The same is true for the investment adviser and financial planning industries. Despite several SEC and congressional proposals to establish one or more SROs for investment advisers, none have been adopted. See, e.g., *Investment Adviser Self-Regulation Act of 1989*, 135 CONG. REC. E. 2736 (1989); see also *Investment Adviser Reform: Hearing on H.R. 578 Before the Subcomm. On Telecomms. And Fin. Of the H. Comm. On Energy and Commerce*, 103d Cong. 8 (1993). The possibility of creating one or more SROs for investment advisers also was raised as a recommendation in the SEC's 1963 study of the securities markets. See REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 88-95, pt. 1, at 158–59 (1963).

As others have noted, the problem of effectively regulating investment advisers was resolved, at least in part, when Congress enacted the National Securities Markets Improvement Act of 1996. See FRANKEL & SCHWING, *supra* note 24, § 1.02[A][8] (citing National Securities Markets Improvement Act, Pub. L. No. 104-290, 104th Cong., 2d Sess., 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code)). Among other reforms, the Act divided jurisdiction over the regulation of investment advisers between the federal government and the states: advisers with more than \$25 million of assets under management must register with the SEC and adhere to federal law whereas advisers managing assets beneath this threshold are regulated by the states pursuant to state law. See Paul S. Stevens & Craig S. Tyle, *Mutual Funds, Investment Advisers, and the National Securities Markets Improvement Act*, 52 BUS. LAW. 419, 443 (1997).

86. Compliance Programs, Fed. Sec. L. Rep. at 87,183.

87. *Id.* at 87,184.

88. *Id.*

The impetus for the 2003 proposal was the SEC's lack of adequate resources, notwithstanding the anticipated substantial increase to the SEC's budget.⁸⁹ In fact, the Release went so far as to predict that "even if we are able to substantially expand our examination staff, it is unlikely that future growth in our resources will ever keep pace with future growth of investment advisers and investment companies."⁹⁰ It bears noting that the 2003 proposal was released for comment in February 2003, more than six months before the revelation of the market timing and late trading scandals that prompted congressional hearings and demands for change.

Industry participants and representatives of the investing public, with very few exceptions, were vehemently opposed to the 2003 proposal. Most commentators questioned the need for change, highlighting the SEC's success with direct regulation and examination of funds⁹¹ and pointing to the mutual fund industry's proud "record of compliance with both the letter and the spirit of the securities laws."⁹² Commentators were also concerned that the establishment of an SRO for mutual funds would create "inconsistent and fragmented layers of regulation"⁹³ and that "forming and operating an SRO would be extremely costly" with such costs ultimately to be borne by investors.⁹⁴ Others bemoaned that self-regulation "would require funds to pay twice, once to the Commission and once to an SRO, for essentially the same amount of oversight they receive today."⁹⁵

The 1983 proposal was developed in a manner similar to the 2003 proposal and met with a similar fate. After more than twenty years of back and forth discussions between SEC officials and industry participants,⁹⁶ in February 1983 the SEC issued a release seeking public comment on the concept of utilizing the private sector to perform routine inspections of

89. *See id.* at 87,182.

90. *Id.*

91. *See* Letter from Craig S. Tyle, Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, SEC (Apr. 17, 2003), *available at* <http://www.sec.gov/rules/proposed/s70303/s70303-15.pdf> ("It bears emphasizing that the current system of Commission oversight of mutual funds has worked exceptionally well for more than sixty years.").

92. *Id.*

93. Letter from David Riggs, Vice President & Assoc. Gen. Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Sec'y, SEC, Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers 5 (Apr. 23, 2003), *available at* <http://www.sec.gov/rules/proposed/s70303/charlesschwab042303.htm>.

94. Hester Peirce, Div. Inv. Mgmt., Compliance Programs of Investment Companies and Investment Advisers: Summary of Contents on Proposed New Rules 38a-1 Under the Investment Company Act and 206(4)-7 Under the Investment Advisers Act, and Proposed Amendments to Rule 204-2 Under the Investment Advisers Act (Nov. 20, 2003), *available at* www.sec.gov/rules/extra/s70303summary.pdf.

95. Letter from Heidi Stam, Principal, Sec. Regulation, Vanguard Group, to Jonathan G. Katz, Sec'y, SEC 6 (Apr. 16, 2003), *available at* <http://www.sec.gov/rules/proposed/s70303/vanguard041603.htm> ("Requiring Commission staff to continue to examine funds and advisers, with the additional burden of overseeing an SRO, ultimately would weaken rather than strengthen the Commission's ability to effectively oversee funds and advisers.").

96. *See supra* note 80 and accompanying text.

mutual funds and other investment companies.⁹⁷ After highlighting the industry's "dramatic growth" and lamenting the "budgetary constraints that prevent the allocation of greater staff resources to the investment company examination program,"⁹⁸ the release sought guidance on a number of alternatives, including the possibility of creating one or more SROs to conduct routine periodic inspections of investment companies.⁹⁹ Under this alternative, the SRO would have the "limited function of conducting examinations of investment companies which elect to participate in such an examination program, and making the results of those examinations available to the Commission."¹⁰⁰ But even with this limited function, an SRO for the purpose of inspecting mutual funds lacked the necessary support from the industry.

The comments from the mutual fund industry in response to the SEC's proposals, particularly the 2003 proposal, reflect the industry's concerns with the costs of private regulation and the fragmentation that could result from concurrent private and public regulation. Some observers might argue that the industry is well aware that the SEC's budget has not kept pace with the explosive growth of mutual funds and that the industry prefers to be regulated by an entity that is strapped for resources. But cutting against this explanation for its reticence to private regulation is the industry's traditional support in Congress for increased SEC appropriations for mutual fund oversight.¹⁰¹

Another explanation for the reticence may be that the mutual fund industry places a high value on its ability to advertise itself as "regulated by the SEC."¹⁰² As Professor Tamar Frankel has observed:

Regulation offers issuers and institutions government support in their efforts to gain investors' trust in the financial markets. Just as it is difficult to validate the trustworthiness of these institutions, it is also very costly for the institutions to convince investors of their trustworthiness. Regulation reduces the institutions' costs. Regulation also helps to restrain the "bad apples" that may ruin confidence in the industry; a few

97. Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13,044, 48 Fed. Reg. 8485 (Feb. 23, 1983).

98. *Id.* at 8486.

99. *Id.* at 8486–87.

100. *Id.* at 8487.

101. See, e.g., *Oversight Hearing on the Mutual Fund Industry*, *supra* note 83, at 95 (statement of Matthew P. Fink, President, Investment Company Institute) ("[The ICI] has for years supported increased funding for the SEC (and for the Division of Investment Management in particular), so that the highly effective regulation that the mutual fund industry has experienced to date will be assured in the future.").

102. Cf. Tamar Frankel, *Regulation and Investors Trust in the Securities Markets*, 68 BROOK. L. REV. 439, 442 (2002). Small investment advisers "vehemently opposed" legislation curtailing federal regulation because "[t]hey wanted to continue to advertise themselves as 'Regulated by the SEC,' which they valued more than the advertising of 'Regulated by State X.'" *Id.*

untrustworthy members may spoil the reputation for trustworthiness for all industry members. Regulation provides the industry with the stamp of “good housekeeping.” It implies that the government guards investors’ interests, and reduces the very high costs that investors would otherwise bear in monitoring the issuers and the institutions.¹⁰³

Earning a “good housekeeping” stamp from the SEC may well be significantly more valuable to the mutual fund industry than a “good housekeeping stamp” from an SRO.

2. Congressional Proposals

After decades of listening to the SEC’s repeated warnings of inadequate resources in the area of mutual fund regulation,¹⁰⁴ in the wake of the market timing and late trading mutual fund scandals, Congress was jolted into action. The result was a series of oversight hearings and a flurry of bills, with some bills proposing new regulations as well as the creation of a “Mutual Fund Oversight Board” modeled on the recently created PCAOB.

Due in part to the upcoming 2004 presidential election, a bill jointly sponsored by Senators John Kerry, Edward Kennedy, and Thomas Daschle—The Mutual Fund Protection Act of 2003—drew substantial attention from the media and financial press. The bill called for the congressional creation of a not-for-profit corporation—the Mutual Fund Oversight Board—which “shall not be an agency or establishment of the United States Government.”¹⁰⁵ As envisioned, it would have possessed registration, investigation, disciplinary, and rulemaking authority over mutual fund directors.¹⁰⁶ The Board’s members would have been selected by the SEC,¹⁰⁷ and it would have been funded by assessments against mutual fund assets or management fees.¹⁰⁸ Providing the rationale for its creation, Senator Kerry maintained:

The actions by the SEC show that it is incapable of protecting investors from securities fraud by mutual fund companies and will not prosecute this type of fraud to the full extent of the law. Therefore, we must take the day-to-day oversight of mutual funds away from the SEC and develop a new Mutual Fund Oversight Board to provide oversight, examination and enforcement of mutual funds. This new board will be similar to the Public

103. *Id.*

104. See, e.g., *Oversight Hearing on the Mutual Fund Industry*, *supra* note 83, at 7–12 (statement of Arthur J. Levitt, SEC Chairman); *Mutual Fund Industry Hearing*, *supra* note 3, at 134–37.

105. Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201(b), 149 CONG. REC. 15,977, 15,984 (2003). Much of the text of the provisions creating the Board was drawn verbatim from Title I of the Sarbanes-Oxley Act, which created the PCAOB. See *infra* notes 113–121 and accompanying text.

106. Mutual Fund Investor Protection Act §§ 202–205 (2003).

107. *Id.* § 201(e)(3).

108. *Id.* § 207(d)(1)–(2).

Company Accounting Oversight Board developed in the Sarbanes-Oxley Act.¹⁰⁹

The Kerry-Kennedy-Daschle bill, along with a number of other bills on the subject of mutual fund reform, failed to proceed very far in Congress.¹¹⁰ To be sure, the demand for reform was high.¹¹¹ But as recounted above, the SEC managed to put forth a convincing case that it was focused on the problems in the mutual fund industry and was proceeding down a path of substantial change.

II. AN ANALYSIS OF PRIVATE SECTOR REGULATION FOR THE MUTUAL FUND INDUSTRY

Private regulation for the securities industry pre-dates the creation of the SEC by almost 150 years.¹¹² Until very recently, this private regulation took the form of self-regulation under SEC oversight, whereby broker-dealers trading on exchanges, and later in the over-the counter market, agreed to comply with detailed rules and principles of fair dealing promulgated by the industry. With the creation of the PCAOB, however, another type of private regulation was born: so-called “independent” private regulation. This part explores both types of regulation and concludes that neither constitutes an appropriate model for the mutual fund industry.

A. INDEPENDENT PRIVATE REGULATION: THE PCAOB MODEL

1. The Structure and Responsibilities of the PCAOB

Congress created the PCAOB in July 2002 as the centerpiece of the Sarbanes-Oxley Act.¹¹³ The PCAOB’s principal mission was to restore investor confidence by preventing the types of accounting scandals that resulted in the collapses of Enron, WorldCom, and numerous other companies in 2001 and 2002.¹¹⁴

109. 149 CONG. REC. S15,984 (Nov. 25, 2003) (statement of Sen. Kerry), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2003_record&page=S15881&position=all.

110. *See supra* note 15; *see also* Tracking of the Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. (2003), *available at* <http://www.govtrack.us/congress/bill.xpd?bill=s108-1958> (noting that the bill was introduced in Congress on November 25, 2003, and the last action on the bill was December 9, 2003).

111. *See supra* notes 44–46 and accompanying text.

112. *See infra* text accompanying note 148.

113. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.).

114. 15 U.S.C. § 7211(a) (Supp. II 2002); *see also* PCAOB, 2003 Annual Report at 5, http://www.pcaobus.org/about_the_pcaob/annual_reports/2003.pdf [hereinafter PCAOB 2003 Annual Report].

As part of this congressionally-designed crackdown, Title I of the Sarbanes-Oxley Act¹¹⁵ charged the ostensibly private PCAOB¹¹⁶ with the broad responsibility of overseeing the audits of public companies (rendering the PCAOB as the auditor's auditor). Specifically, the legislation provided that the PCAOB shall: register accounting firms that audit public companies;¹¹⁷ enact rules setting standards for auditing, quality control, ethics, and independence;¹¹⁸ inspect on a yearly basis the nation's largest accounting firms and inspect other firms at least once every three years;¹¹⁹ investigate possible violations of PCAOB rules or the federal securities laws by accounting firms and their associated persons;¹²⁰ and impose discipline for established violations through a range of sanctions including censures, temporary suspensions, permanent bars, and substantial monetary fines.¹²¹

Congress also charged the SEC with ultimate oversight of the PCAOB (rendering the SEC, in a manner of speaking, the auditor of the auditor's auditor). Specifically, the SEC appoints the PCAOB's Chairperson and its four other members (who can only be removed for cause);¹²² approves the PCAOB's budget;¹²³ approves any rules adopted by the PCAOB;¹²⁴ and retains review power over any disciplinary actions taken by the PCAOB.¹²⁵

The PCAOB was deemed fully operational by the SEC on April 25, 2003.¹²⁶ Since that time, the PCAOB has grown into an organization with approximately 450 employees in Washington, D.C. and seven regional offices, and an operating budget of \$130.5 million for fiscal year 2006.¹²⁷ Congress provided that its primary source of funding—often referred to as “private sector funding”—was to come from the “accounting support fees” that the PCAOB was authorized to levy on public companies in accordance with a formula based on market capitalization.¹²⁸

115. 15 U.S.C. §§ 7211–7219 (Supp. II 2002).

116. Title I provides that “[t]he Board shall not be an agency or establishment of the United States Government,” and that “[n]o member or person employed by, or agent for, the Board shall be deemed to be an officer or employee of or agent for the Federal Government by reason of such service.” *Id.* § 7211(b).

117. *Id.* § 7211(a).

118. *Id.* § 7211(c)(2).

119. *Id.* § 7214(b)(1)(A)–(B).

120. *Id.* § 7211(c)(4).

121. *Id.* § 7215(c)(4)(A)–(D).

122. *Id.* § 7211(e)(4), (6).

123. *Id.* § 7219(b).

124. *Id.* § 7217(b)(2).

125. *Id.* § 7217(c)(2).

126. PCAOB, 2003 Annual Report, *supra* note 114, at 5.

127. PCAOB: Public Company Accounting Oversight Board, 2006 Budget 5, http://www.pcaobus.org/About_the_PCAOB/Budget_Presentations/2006.pdf.

128. 15 U.S.C. § 7219(c)(1), (g).

2. Should an Independent Oversight Board be Established for Mutual Funds?

I have argued previously that the decision to create the PCAOB as a private entity was profoundly unwise, both for doctrinal reasons as well as normative ones.¹²⁹ To be sure, the accounting profession was sorely in need of restructured regulation and Congress was right to take up that task. But Congress's resort to the legal fiction that the PCAOB is a private corporation jeopardizes the PCAOB's ability to fulfill its role as the accounting industry's principal regulator.

Prior Supreme Court precedent makes very clear that, for purposes of the U.S. Constitution, the PCAOB is part of the federal government notwithstanding its congressional designation as a private corporation. The decision most directly on point is *Lebron v. National Railroad Passenger Corp.*,¹³⁰ where the Court set forth a three prong test for determining whether an ostensibly private entity is actually part of the "Government itself."¹³¹ Under *Lebron*, when (1) "the Government creates a corporation by special law," (2) "for the furtherance of governmental objectives," and (3) "retains for itself permanent authority to appoint a majority of the directors of that corporation," that "corporation is part of the Government," at least for purposes of constitutional law.¹³² Thus, federal courts—including one at this very moment in the U.S. District Court for the District of Columbia¹³³—must now grapple with whether the PCAOB's structure comports with the Appointments Clause and the doctrine of separation of powers. And even if these threshold issues are resolved in the PCAOB's favor, other challenges against the constitutionality of the PCAOB's actions will invariably follow.¹³⁴

Congress's decision to create the PCAOB as a private corporation is also troubling from a policy perspective. As a private entity, even one that is subject to SEC oversight, the PCAOB is less publicly accountable, its operations are less transparent, and its policymaking is less legitimate than its federal regulatory counterparts.¹³⁵ Moreover, the PCAOB's status as a private corporation raises, rather than lowers, the overall costs of its regulatory program. Had the PCAOB been established as a federal entity, it

129. See Nagy, *supra* note 9, at 1048–57, 1061–69.

130. 513 U.S. 374 (1995). In *Lebron*, an 8–1 majority of the Supreme Court held that Amtrak was part of the federal government, notwithstanding Congress' statutory declaration that it is a private corporation and "not . . . an agency or establishment of the United States Government." *Id.* at 391.

131. *Id.* at 397.

132. *Id.* at 400.

133. See *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, No. 1:06-cv-00217-JR, 2006 WL 645100 (D.D.C. Feb. 7, 2006).

134. See Nagy, *supra* note 9, at 1044.

135. See *id.* at 1062–66.

could be operating more cost effectively, in part because the compensation to its members and staff likely would have been less.¹³⁶

My opinion about the appropriateness of the PCAOB model for the mutual fund industry should therefore come as no surprise: Congress should not compound its mistake in creating the PCAOB as a private corporation by establishing a new centaur-like entity for the mutual fund industry. Such an entity would surely fall prey to the same constitutional challenges and policy indictments currently being launched at the PCAOB.

3. The Road Not Taken—Independent Government Regulation

At the congressional hearings that preceded the enactment of the Sarbanes-Oxley Act, U.S. Comptroller General David Walker testified that while there were “several alternative structures” from which Congress could choose in establishing a new regulator for the accounting industry, the one that he favored would have created “an independent government entity within the SEC.”¹³⁷ His second favored alternative, possibly modeled on the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, would have created “an independent government agency outside the SEC.”¹³⁸ He did not favor the creation of “a non-governmental private-sector entity overseen by the SEC” because such a “body would have less direct accountability to the Congress and the public than a body with board members who are PASs [president appointed confirmed by the Senate].”¹³⁹

136. Of course, some would argue that the regulator for the accounting industry “needed” to be private because the regulator “needed” to pay private-sector salaries to attract highly qualified board members and staff. *See, e.g., The Fourth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law*, 9 FORDHAM J. CORP. & FIN. L. 583 (2004).

We were created as a not-for-profit corporation largely so the PCAOB could pay better than government. . . . [Members of Congress] realized that they were piling an immense responsibility on a startup, and so one of the things they figured out is you’re going to have to pay people better than the government can pay

Id. (quoting William McDonough, PCAOB Chairman); *see also* Nagy, *supra* note 9, at 1069 n.501 (citing additional sources). But a sufficient number of talented accountants and lawyers may well have been eager to sign on with a new public sector regulator for the accounting industry, and a pay scale on par with the SEC or federal banking regulators may not have dissuaded them. Furthermore, even if there were a legitimate need for the accounting regulator to pay wages above those paid by the SEC and the federal bank regulators, no structural impediment would have prevented Congress from authorizing the disparity. The only barriers were political, not legal. *See id.* at 1068–69.

137. *See* U.S. GEN. ACCT. OFFICE, THE ACCOUNTING PROFESSION: STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM, REP. NO. GAO-02-411, at 79 (May 2002) (Letter from David M. Walker, U.S. Comptroller Gen., to Hon. Paul Sarbanes, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate 5 (May 3, 2002)), *available at* <http://www.gao.gov/new.items/d02411.pdf>.

138. *Id.*

139. *Id.*

He also expressed concern that a private sector entity “would increase the SEC’s responsibility as well as its workload.”¹⁴⁰

Short of a Supreme Court decision invalidating the PCAOB’s current structure as unconstitutional, however, there is little reason to expect Congress to revisit this issue and recreate the PCAOB as an independent government regulator. That reality is unfortunate because the road not taken would have led to a stronger PCAOB that was more aligned with democratic values.

The possibility of independent government regulation remains open for the mutual fund industry. Yet a path down that road would make little sense. In the case of accounting, the creation of an entirely new entity was warranted because the SEC did not have a long and established tradition of inspecting and regulating the practice of auditing, and the need to replace the prior system of self-regulation was clear.¹⁴¹ Mutual funds, in contrast, have been inspected and regulated by the SEC for the last 65 years, with notable success and only infrequent criticism.¹⁴² In light of that experience, it is difficult to see how a new federal regulator could oversee the mutual fund industry any more efficiently or effectively with the same expenditure of resources.

Moreover, to the extent that the SEC’s shortcomings in regulating mutual funds can be attributed to agency capture, the potential for capture would only be increased in a newly created federal agency designed to focus exclusively on the regulation of the mutual fund industry. Indeed, as others have noted, “a well-known empirical regularity is that single industry regulators are typically more prone to capture than [multi]–industry regulators.”¹⁴³

B. SELF-REGULATION: THE NASD AND NYSE MODEL

1. Self-Regulation as Distinguished from the PCAOB

The recent litigation challenging the constitutionality of the PCAOB has focused renewed attention on the structural similarities between the PCAOB and the NASD and NYSE, and has prompted some to question whether a determination that the PCAOB is part of the federal government would jeopardize the legal status of these SROs.¹⁴⁴ To be sure, as the SEC

140. *Id.*

141. See Nagy, *supra* note 9, at 984.

142. See Birdthistle, *supra* note 6, at 1408.

143. *Trading Abuses Hearing*, *supra* note 1, at 61 (testimony of Eric W. Zitzewitz, Stanford Graduate School of Business). For an extensive overview of capture theory and the debates surrounding it, see IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 54–73 (1992).

144. See, e.g., John C. Coffee, Jr., *Is the PCAOB Unconstitutional?*, 235 N.Y.L.J. 5 (2006).

tacitly acknowledged in *The Matter of Frank Quattrone*,¹⁴⁵ the NASD and the NYSE's close entwinement with the SEC raises legitimate questions as to whether some SRO actions should be deemed "state action" for purposes of the Constitution.¹⁴⁶ But under the Supreme Court's decision in *Lebron*, neither the NASD nor the NYSE should be deemed the "government itself." Taking the three prongs of the test in *Lebron*,¹⁴⁷ we can see why this is so.

Focusing on the first prong, neither the NASD nor the NYSE were "created" by Congress. Although Congress created a scheme of statutory self-regulation pursuant to which both entities are afforded certain quasi-government powers, both the NASD and the NYSE were formed by members of the industry they regulate—the "self" in self-regulation. The NYSE was established in 1792 when a group of securities brokers signed the "Buttonwood Agreement."¹⁴⁸ The NASD can trace its roots back to 1912 when a group of investment bankers formed the Investment Bankers Association of America (IBA).¹⁴⁹ In contrast, the PCAOB owes its entire

145. In the Matter of Frank P. Quattrone, Exchange Act Release No. 53,547 (Mar. 24, 2006), available at <http://www.sec.gov/litigation/opinions/34-53547.pdf> (setting aside NASD summary disposition imposing a lifetime ban because Quattrone's introduction of "specific facts to support his contention that NASD engaged in state action as a joint actor with the Commission" earned him the right to an evidentiary hearing under NASD rules).

146. See *infra* notes 157–158 and accompanying text.

147. See *supra* notes 132 and accompanying text.

148. See About the NYSE: History, Firsts & Records, <http://www.nyse.com/about/history/1022221392987.html>.

149. See PROCEEDINGS OF THE ORGANIZATIONAL MEETING AND OF THE FIRST ANNUAL CONVENTION OF THE INVESTMENT BANKERS' ASSOCIATION OF AMERICA 12 (August 8, 1912) (Address of Chairman George Caldwell). See also Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 23–24 (Jan. 2001) (discussing the predecessor organizations to the NASD); VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 165 (Ralph W. Hidy ed., 1970) ("[The IBA] was the industry's united response to mounting public criticism and increasing demands for regulatory legislation."). In 1933, the IBA availed itself of the self-regulatory framework provided in the National Industrial Recovery Act (NIRA), ch. 90, 48 Stat. 195 (1933), and formed the Investment Bankers Code Committee (IBCC), charging it with the establishment of a code of fair competition. President Roosevelt approved that code in November 1933, but it fell victim to the Supreme Court's decision in *Schechter Poultry Corp. v. United States*, 295 U.S. 495, 551 (1935), which declared the NIRA unconstitutional. Most investment bankers "continued to adhere to the code voluntarily," and in 1936, the IBCC (which reorganized itself informally as the Investment Bankers Conference Committee (the "Conference Committee")) began working with the SEC "to establish a new, permanent nationwide organization under the SEC." CAROSSO, *supra*, at 389. According to Carosso, the Conference Committee's "most important contribution was to draft the legislation subsequently passed as the Maloney Act." *Id.* at 390. The Maloney Act added Section 15A to the Exchange Act, specifying the criteria pursuant to which the SEC may register "national securities associations" with rulemaking, investigative, and enforcement authority over their members. After the Maloney Act's passage in 1938, the Conference Committee again reorganized to form the NASD, and in August 1939, the SEC formally registered the NASD as the nation's first, and until the recent registration of the National Futures Association, only national securities association. See, e.g., Robert Glauber, Chairman and CEO, NASD, Testimony Before the Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. of the Comm. on Fin. Servs., U.S. H.R. Hearing on Self-Regulatory Organizations: Exploring the Need for Reform 1 (Nov. 17, 2005), available at

existence and structure to Congress.¹⁵⁰ That is, as previously noted, Congress designed the PCAOB and specified that it was to have five members; Congress imposed for PCAOB members a limit of two terms; Congress protected PCAOB members from removal except by the SEC (and then only for good cause); and Congress assigned the PCAOB its very specific oversight responsibilities. Moreover, to separate the PCAOB further from its self-regulatory cousins, Congress specifically provided that no more than two CPAs can serve as members at any one time.¹⁵¹

Skipping to the third prong of the *Lebron* test, it is also clear that neither the NASD nor the NYSE are controlled by a board that is appointed by the government. Both entities select their own boards and the government plays no role in the appointment of NASD or NYSE directors.¹⁵² In stark contrast, the SEC appoints the PCAOB's board (after consultation with the Chairman of the Federal Reserve and the Secretary of the Treasury) and only the SEC can remove PCAOB members—and then only for cause.

Some courts applying the *Lebron* test also look to government funding of an ostensibly private entity as an additional indicia of governmental

<http://financialservices.house.gov/media/pdf/111705rg.pdf> [hereinafter Testimony of Robert Glauber, NASD Chairman and CEO].

150. It is instructive to compare the PCAOB to the system of accounting regulation proposed in an alternative bill that was drafted by Congressman Michael Oxley. See Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. (2002), available at <http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3763>: [hereinafter CAARTA]. Passing overwhelmingly in the House by a vote of 334 to 90, see Final Vote Results For Roll Call 110, Corporate and Auditing Accountability and Responsibility Act, H.R. 3763 (Apr. 24, 2002) (recorded vote), <http://clerk.house.gov/evs/2002/roll110.xml>, but later abandoned in favor of a Senate bill proposed by Senator Paul Sarbanes, the Oxley bill would have permitted the SEC to recognize “public regulatory organization[s]” for the accounting industry in a way similar to which the SEC was authorized to recognize the NASD as a “national securities association.” See CAARTA, *supra*, § 2(b). Had the PCAOB been developed in this cooperative manner by the SEC and the accounting industry, that entity properly could have been described as a self-regulatory organization. But the PCAOB was a congressionally-created *independent* regulation—it is not a self-regulator. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.).

151. 15 U.S.C. § 7211(e)(2) (Supp. II 2002).

152. In December 2004, the SEC released for public comment proposed rules that would have required registered “national securities exchanges” and registered “national securities associations” to have a governing board “composed of a majority of independent directors, with key board committees to be composed solely of independent directors.” Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126 at 71,133 (Dec. 8, 2004). The proposed rules would also require these SROs to separate, either structurally or functionally, their regulatory operations from their market operations and other commercial interests. *Id.* at 71,141–43. Although the SEC has not adopted these proposals as rules, both the NASD and the NYSE have adopted structural changes that would bring the SROs more in line with these proposals. See, e.g., NYSE Supports Targeted Improvements to Self Regulation (April 2005), <http://www.nyse.com/about/publication/1113302997067.html>; Testimony of Robert Glauber, NASD Chairman and CEO, *supra* note 149, at 2–3.

control.¹⁵³ But here again we see a significant difference between the NASD/NYSE and the PCAOB: both the NASD and the NYSE receive their funding from the members they regulate, whereas the PCAOB's funding stems from a congressional mandate effectively requiring public companies to pay "accounting support fees."¹⁵⁴ Thus, even if the "government control" prong of the *Lebron* test is viewed more flexibly,¹⁵⁵ it is highly unlikely that a court would deem either the NYSE or the NASD as an entity "controlled" by the government.

Returning to the second prong under *Lebron*, there is certainly no denying that Congress vested the NASD and the NYSE with government-like rulemaking, investigative and disciplinary powers and that these SROs, in the words of *Lebron*, further important "governmental objectives."¹⁵⁶ But while a necessary condition, that is hardly sufficient to deem an entity the government itself. Indeed, if furthering important "governmental objectives" were the sine qua non of a public entity, than a host of services frequently "contracted out" by the government—including education, medical care, transportation, and insurance—would be forever removed from the private sector.

The government-like rulemaking, investigative and disciplinary powers of the NASD and NYSE do, however, make these entities susceptible to constitutional challenges on the ground that their actions constitute "state action" under Supreme Court precedents.¹⁵⁷ Such challenges have in the past been met with mixed success.¹⁵⁸

153. See, e.g., *Gorman-Bakos v. Cornell Cooperative Extension of Schenectady County*, 252 F.3d 545, 552–53 (2d Cir. 2001) (concluding in dicta that the state-created and state funded agricultural cooperative was a state actor even though only two of its ten board members were appointed by the government).

154. See 15 U.S.C. §§ 7219(c)(1), (g) (Supp. II 2002).

155. See, e.g., *Sotack v. Pa. Prop. & Cas. Ins. Guar. Ass'n*, 104 F. Supp. 2d 471, 478 (E.D. Pa. 2000) (finding that because the Commissioner of Pennsylvania's Department of Insurance "has virtually limitless authority to supervise and regulate [the] PPCIGA at all times," the PPCIGA satisfies the "control" prong in *Lebron*, even though "the members of the Board are typically not appointed by the government").

156. *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 400 (1995).

157. Traditional state action analysis requires a court to determine whether "there is a sufficiently close nexus between the State and the challenged action." *Am. Mfrs. Mut. Ins. Co. v. Sullivan*, 526 U.S. 40, 52 (1999) (holding that private insurer who withheld payment was not a state actor despite being subject to extensive government regulations). More recently, the Court has focused on the private entity's overall "entwinement" with the government. See *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 302 (2001) ("Entwinement to the degree shown here" supports the conclusion that the TSSAA "ought to be charged with a public character and judged by constitutional standards."). The scholarly literature on the so-called state action doctrine is voluminous. For insightful overviews, see Erwin Chemerinsky, *Rethinking State Action*, 80 NW. U. L. REV. 503 (1985); Ronald J. Krotoszynski, *Back to the Briarpatch: An Argument in Favor of Constitutional Meta-Analysis in State Action Determinations*, 94 MICH. L. REV. 302 (1995); Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003).

158. *Compare Villani v. N.Y. Stock Exch., Inc.*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) ("It is now beyond dispute that the Fifth Amendment due process requirements as to federal action

2. Should an SRO be Established for Mutual Funds?

Having drawn the distinction between the PCAOB (an ostensibly private *independent* regulatory body) and the NASD and NYSE (private *self-regulatory* bodies), we can now explore the question of whether an SRO modeled on the NASD or NYSE should be established for the mutual fund industry. Although self-regulation under SEC oversight has worked reasonably well for the broker-dealer industry,¹⁵⁹ such a self-regulatory system should not be established for mutual funds.¹⁶⁰

Many of the arguments against the creation of an SRO for mutual funds relate to the well-recognized weaknesses inherent to any system of self-regulation. As a congressional committee observed more than 30 years ago:

The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.¹⁶¹

With respect to broker-dealers, both Congress and the SEC have determined that these disadvantages are outweighed by the benefits of self-regulation. Among other benefits:

apply to the disciplinary hearings conducted by the Exchange.”), *aff’d sub nom.* Sloan v. N.Y. Stock Exch., Inc., 489 F.2d 1 (2d Cir. 1973), *and* Intercontinental Indus., Inc. v. Am. Stock Exch., 452 F.2d 935, 941 (5th Cir. 1971) (“The intimate involvement of the Exchange with the [Commission] brings it within the purview of the Fifth Amendment controls over governmental due process.”), *with* United States v. Solomon, 509 F.2d 863, 867–68 (2d Cir. 1975) (finding that NYSE’s status as a private institution insulates it from defendant’s claim that he was denied the Fifth Amendment’s privilege against self-incrimination), *and* Jones v. Sec. Exch. Comm’n, 115 F.3d 1173, 1183 (4th Cir. 1997) (rejecting defendant’s constitutional challenge under the Double Jeopardy Clause in part because “[w]hile the NASD is a closely regulated corporation, it is not a governmental agency, but rather a private corporation organized under the laws of Delaware”). For articles analyzing whether constitutional protections should apply to SRO disciplinary actions, see William I. Friedman, *The Fourteenth Amendment’s Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited*, 23 ANN. REV. BANKING & FIN. L. 727 (2004); Richard L. Stone & Michael Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453 (1995).

159. But as the SEC itself recognized in its 2004 Concept Release on self-regulation, “recent failings or perceived failings with respect to SROs fulfilling their self-regulatory obligations have sparked public debate as to the efficacy of the SRO system in general.” Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,257 (Dec. 8, 2004).

160. For additional scholarly commentary on this question, see Seligman, *supra* note 8, at 1120–26 and Frankel, *supra* note 8, at 448–50.

161. Staff of S. Comm. on Banking, Housing and Urban Affairs, 93d Cong., Report of the Subcomm. on Securities (Comm. Print 1973), *quoted in* Seligman, *supra* note 8, at 1120.

The expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals of regulation and their own stake in it. In some areas the self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law.¹⁶²

But for a variety of reasons, the calculus performed for the broker-dealer industry would not yield the same result for the mutual fund industry. Indeed, for mutual funds, the benefits of self-regulation would be far less meaningful and the disadvantages would be substantially greater.

As Part I of this article has demonstrated, mutual funds already operate under a highly specific and demanding system of statutory regulation that has been in existence for more than 65 years. That was not the case for broker-dealers when Congress opted to delegate substantial rulemaking, investigative, and disciplinary authority to the stock exchanges in 1934 and to the NASD in 1939.¹⁶³ Thus, SROs operating under SEC oversight spared the SEC and Congress much heavy lifting in the area of broker-dealer regulation. In the case of mutual funds, however, the heavy lifting has already been done by the government. It is impossible to turn back the clock to recapture that significant self-regulatory advantage.

An SRO for mutual funds also cannot be justified as a cost-savings measure. As the mutual fund industry has been quick to point out, the creation of an SRO would be tremendously expensive and the SRO's funding would in all likelihood have to come—directly or indirectly—from mutual fund shareholders.¹⁶⁴ Such membership fees to the SRO would be on top of the substantial registration and filing fees already paid to the SEC by funds and advisers.¹⁶⁵ The SEC, in turn, would face the added cost of overseeing this new SRO. And given the SEC's statement in its 2003 proposal that its "staff would continue to examine the activities of funds and advisers,"¹⁶⁶ there would be little reason to expect a significant offsetting reduction in the SEC's present costs of mutual fund regulation.

Moreover, the self-regulatory promise of higher standards of ethical behavior holds less value in the mutual fund industry, where the securities law itself demands a very high standard of conduct. Unlike broker-dealers who generally deal in arms-length transactions with their customers and

162. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. DOC. NO. 88-95, at 722 (1963).

163. See *supra* notes 148–49 and accompanying text.

164. See *supra* notes 93–95 and accompanying text.

165. But cf. Seligman, *supra* note 8, at 1126 (expounding the benefits of an SRO for mutual funds, but acknowledging that whether they are worth the costs is an empirical question meriting serious study).

166. See Compliance Programs, Investment Company Act Release No. 25,925, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,827, at 87,184 (Feb. 5, 2003).

other broker-dealers,¹⁶⁷ investment companies and their investment advisers owe fiduciary duties to the shareholders who entrust their money to mutual funds.¹⁶⁸ The critical question then is who is better positioned to ensure that the mutual fund industry adheres to those very high standards—the SEC or the industry itself?

There should be little doubt that, as the federal agency charged with the responsibility of protecting investors, the SEC would be far more effective than the industry in ensuring that mutual funds and their advisers adhere to the very high standards of conduct proscribed by the law. A mutual fund SRO would suffer from the same inherent conflicts of interest that occur whenever an industry has principal responsibility for overseeing the policies and practices of its members. But the creation of a mutual fund SRO laden with these conflicts is particularly troubling because mutual funds already operate under a built-in conflict resulting from their management by affiliated investment advisers.¹⁶⁹ Although SEC officials (not to mention members of Congress) may be susceptible to pressure from the mutual fund industry to lessen the burdens of regulation and enforcement, that pressure does not even come close to the daily conflicts that would be faced by regulators selected by and responsible to the firms that are members of the SRO.

The SEC would also be less likely to promulgate rules aimed specifically to discourage competition. In contrast, a mutual fund SRO may frequently be tempted to use its control over membership to thwart competition. Although the tendency toward anti-competitive behavior is a general weakness of self-regulation,¹⁷⁰ that concern is exacerbated in the context of mutual fund regulation because of the industry's relatively low start-up costs and barriers to entry.¹⁷¹

A final reason for opposing the creation of an SRO for mutual funds is the very practical issue of timing. The mutual fund reforms undertaken by

167. See Barbara Black, *Brokers and Advisors—What's in a Name?*, 11 FORD. J. CORP. & FIN. L. 31, 36 (2005) (“A broker-dealer’s relationship with his customers is not, however, generally considered a fiduciary one, unless the broker exercises investment discretion over the customer’s account.”).

168. See FRANKEL & SCHWING, *supra* note 24, § 1.02[A][3] (“[B]oth the Advisers Act and the 1940 Act are based on the central premise that investment advisers are fiduciaries of their clients.”).

169. *Burks v. Lasker*, 441 U.S. 476, 480 (1970) (observing that the 1940 Act responded to Congress’s “concern[] about the potential for abuse inherent in the structure of investment companies”). See generally Mahoney, *supra* note 43, 161–75 (describing the structure of mutual funds and the inherent conflicts facing advisers and broker-dealers).

170. See generally Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475, 487 (1984).

171. See *The Mutual Fund Summit Transcript*, 73 MISS. L.J. 1153, 1157 (2004) (emphasizing that the investment company industry is one “that has very low barriers to entry, many new entrants and a great deal of competition” (quoting Paul Hagg, former Chairman of the Investment Company Institute)).

the SEC in the wake of the trading abuse scandals have not been in place for long and their effectiveness is still being evaluated. A drastic change in the course of mutual fund regulation might undermine the investor confidence that both the SEC and the industry itself has been working diligently to restore.¹⁷²

III. TOWARD MORE EFFECTIVE REGULATION OF MUTUAL FUNDS

What then, if anything, can be done to improve the way in which mutual funds are regulated? This final Part offers several suggestions. The first constitutes a somewhat ambitious undertaking that would require congressional action. But three more modest recommendations are also advanced.

A. AN EXPANDED AND ENHANCED SEC

Assuming that further study demonstrates the desirability of more frequent and/or more comprehensive inspections for mutual funds and their advisers, one possibility would be for Congress to infuse the SEC with additional resources to accomplish that end. Such additional funding could bring the SEC more in line with the substantially lower examiner-to-assets ratios, and the examiner-to-entity ratios, that exist for federal bank regulators such as the Federal Reserve and FDIC.¹⁷³ This observation should not be viewed as an argument for complete parity with federal bank regulator ratios. To be sure, many experts contend that the U.S. banking industry is substantially over-regulated.¹⁷⁴ But in light of the sheer volume of money currently invested in mutual funds,¹⁷⁵ a forceful argument can be

172. See Frankel, *supra* note 8, at 455 (“[D]ifferent, untested scheme of regulation” for mutual funds may be perceived by the public as a sign of “reduced regulatory supervision.”).

173. See U.S. GOV’T ACCOUNTABILITY OFFICE, MUTUAL FUND INDUSTRY: SEC’S REVISED EXAMINATION APPROACH OFFERS POTENTIAL BENEFITS, BUT SIGNIFICANT OVERSIGHT CHALLENGES REMAIN, REP. NO. GAO-05-415 (Aug. 2005). The GAO reported that the then \$8 trillion in assets held by mutual funds and other investment companies at the start of fiscal year 2005 was “nearly double the \$4.5 trillion in insured deposits at commercial banks and about equal to the \$8 trillion of financial assets at commercial banks.” *Id.* at 15. The GAO further reported that in 2004, the SEC had 495 examiners managing 9,517 entities (including investment advisors (8,535) and fund complexes (982)); the Federal Reserve had 1,223 examiners managing 6,970 entities (bank holding companies (5,863), state member banks (919), and foreign banking organizations (188)); and the FDIC had 1,824 examiners managing 5,272 entities (FDIC-insured, state-chartered institutions not members of the Federal Reserve System). *Id.* at 16.

174. See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 18 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., and Bus. Discussion Paper Series, Paper No. 521, 2005), available at http://www.law.harvard.edu/programs/olin%5Fcenter/papers/pdf/Jackson_521.pdf (“[O]ne area in which U.S. regulatory intensity is unambiguously out of line” with other countries studied “is in the field of banking,” and “[e]ven adjusted for total banking assets, the costs of banking regulation in the United States is dramatically higher than the costs in any other [studied] jurisdiction.”).

175. See *supra* note 2 and accompanying text.

made that the current system of inspection should be expanded and enhanced.

Assuming an expanded and enhanced SEC mutual fund inspection program is warranted, the additional monies to the SEC need not come from general federal appropriations. Rather, following the “full cost recovery” model of the Federal Reserve and the FDIC, Congress could authorize the SEC to retain the registration and filing fees that currently are paid by mutual funds and their advisers and, if necessary to fund the enhanced program, could authorize higher fees.¹⁷⁶ Although Congress has rejected self-funding proposals for the SEC in the past,¹⁷⁷ this proposal would be on a more limited scale and would preserve for Congress much of its coveted control over the SEC’s budget.

Alternatively, Congress could authorize the SEC to charge mutual funds or their advisers for the cost (or partial costs) of enhanced inspections and examinations. Although these charges may be passed along to fund shareholders in the form of reduced profits, the cost of an enhanced SEC inspection program would be substantially lower than the creation of an entirely new federal regulatory entity or a new self-regulator along the lines of the NASD and NYSE.

B. OTHER REFORMS

1. Heightened Enforcement of Duties for Mutual Fund Directors

Many scholars have emphasized that the trading abuse scandals reflected a systemic failure of oversight by mutual fund boards.¹⁷⁸ Although the SEC has enacted a number of new rules to strengthen the oversight role of mutual fund boards,¹⁷⁹ the SEC can and should do a better job of holding mutual fund directors to their statutory responsibilities.

In particular, the SEC should set forth clearer standards regarding the minimal level of diligence that independent directors must demonstrate to

176. In May 2006, the SEC announced that the registration and transaction fees charged to securities issuers and other parties will be reduced by \$1 billion in the fiscal year that begins October 1. See SEC Press Release 2006-64, SEC Announces Billion Dollar Fee Cut to Benefit Investors, May 3, 2006, available at <http://www.sec.gov/news/press/2006/2006-64.htm>. For securities issuers, including mutual funds, this change amounts to a fee reduction of 71%. *Id.* But if necessary to fully fund an enhanced mutual fund inspection program, this fee reduction could be readjusted.

177. See Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 233, 246–49, 253–56 (2004).

178. See, e.g., *Looking Out for Investors Hearing*, *supra* note 9, at 152 (prepared statement of Professor Mercer Bullard) (“[A]ll of the frauds share a common element: the failure of mutual fund boards to satisfy fundamental standards of compliance oversight.”).

179. See *supra* notes 52–53 and accompanying text.

fulfill their role as “watchdogs” of the management of mutual funds.¹⁸⁰ As Professor Alan Palmiter points out in his article for this Symposium, a comprehensive specification of board duties is noticeably absent from the ‘40 Act, and thus it is generally state, rather than federal, law that determines whether mutual fund directors are fulfilling their duties to shareholders.¹⁸¹ But certain oversight and monitoring responsibilities—such as those involving fund fees and performance as well as the pricing of portfolio securities—are duties which are specifically set out in the ‘40 Act and its rules and regulations.¹⁸² If SEC officials articulated their expectations for independent directors more clearly and more directly, independent directors may well increase their vigilance in response.

The SEC must also be more willing to initiate enforcement actions and seek sanctions, including monetary penalties and officer and director bars, against independent directors who flagrantly disregard their duties.¹⁸³ As Commissioner Roel C. Campos emphasized in a written dissent to a settled proceeding against the four independent directors of Heartland Group Funds,¹⁸⁴ the failure to impose severe sanctions against outside directors in the face of egregious misconduct undercuts the SEC’s recent initiatives to strengthen the responsibilities of independent directors and “diminishes the solemn obligation and duty of directors being vigilant in protecting the interests of shareholders.”¹⁸⁵ Independent directors who recklessly fail to fulfill their oversight responsibilities may be liable under the broad fiduciary provision in Section 36(a) of the ‘40 Act, and depending on the particular facts and circumstances, may be liable for aiding and abetting fraud under Section 10(b) and Rule 10b-5 of the Exchange Act and Section 17(a)(1) of the Securities Act.¹⁸⁶ Independent directors who act negligently but not recklessly may be liable for violating Sections 17(a)(2) and (3) of

180. See Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133, 152 (2005) (“Currently, fiduciary duties are so broadly defined as to be almost meaningless Strengthening fiduciary duties is one of the key elements remaining for effective mutual fund reform.”) (internal quotation marks omitted). See also Mercer Bullard, *Rouge on a Corpse Won’t Bring Mutual Fund Directors Back to Life*, JURIST ONLINE (Mar. 15, 2004), <http://jurist.law.pitt.edu/forum/bullard1.php> (“Neither the SEC nor the fund industry has set forth standards regarding the minimum steps that fund directors must take to fulfill their fiduciary duties to shareholders.”).

181. Alan R. Palmiter, *Mutual Fund Boards: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 165–66 (2006).

182. See, e.g., Investment Company Act § 15(c), 15 U.S.C. § 80a-15(c) (2000); 17 C.F.R. § 270.22c-1 (2006).

183. See Bullard, *supra* note 180 (criticizing the SEC’s enforcement program for failing to demonstrate “that directors will be held accountable for the gross disregard of their duties”).

184. See *In re Hammes*, Investment Company Act Release No. 26,290A (Jan. 7, 2004) (Roel C. Campos, Comm’r, dissenting), available at <http://www.sec.gov/litigation/admin/33-8346a.htm>.

185. *Id.* See also Hillary A. Sale, *Independent Directors as Securities Monitors*, 62 BUS. LAW. (forthcoming Nov. 2006) (“[T]argeted SEC enforcement actions against independent directors could be a powerful incentive to animate the securities monitoring role.”).

186. See *id.*

the Securities Act, provisions which do not require the SEC to make a showing of scienter.

2. Returning OCIE Staff to the Policymaking Divisions

Another possible reform for the SEC to consider would involve dismantling the OCIE and returning staff examiners to their respective operating divisions.¹⁸⁷ As others have noted, increased interaction among the OCIE's approximately 500 examiners for investment companies/advisers and the 200 or so members of the staff of the Division of Investment Management may allow problems and abuses to be identified more quickly, which may result in more effective and efficient mutual fund rulemaking.¹⁸⁸

Although the views of the current SEC staff, in particular directors and associate directors, should be sought and carefully considered, it is instructive to note that several former Directors of the Division of Investment Management have argued forcefully for a change. Specifically, these directors emphasize that frequent contacts and exchanges between examiners and division staff provides "interactive benefits" that result in higher quality rules and policies.¹⁸⁹

3. Continued Cooperation with the ICI

As noted above, often-cited advantages of self-regulation include industry expertise and the greater sense of stake in the process that comes when industry members participate in the development of rules.¹⁹⁰ To these ends, the SEC should heighten its interactions with the Investment

187. The OCIE was established in 1995 during the Chairmanship of Arthur Levitt. It was formed by consolidating the inspection and examination programs authorized by the Exchange Act, the Investment Company Act, and the Investment Advisers Act, responsibility for which had previously been divided between the Division of Market Regulation and the Division of Investment Management. See Lori A. Richards and John H. Walsh, *Compliance Inspections and Examinations by the Securities and Exchange Commission*, 52 BUS. LAW. 119 (1996).

188. Proposals for the dissolution of the OCIE are currently being considered both at the SEC and in Congress. See Paul Akins, SEC Commissioner, Remarks before the IA Compliance Best Practices Summit 2005 (Mar. 4, 2005), available at <http://www.sec.gov/news/speech/spch022806psa.htm> (questioning whether it would "make more sense for us to reintegrate examiners into the Divisions" and stating that "[a]n integrated structure could allow for interaction and exchange between the folks who write and interpret rules and those who are on the frontlines interacting with registrants and assessing their compliance with our rules"); Rachel McTague, *Securities and Exchange Commission: Fossella Bill Would Disband SEC's OCIE, Redistribute Agency's Inspections Power*, 38 SEC. REG. & L. REP. 55 (2006) (reporting on H.R. 4618, introduced by Rep. Vito Fossella (R.-NY)).

189. See American Enterprise Institute, *supra* note 8. Marianne Smythe, who directed the Division of Investment Management from 1990–93, agreed with one audience participant who characterized inspectors and examiners as the "eyes and ears" of division directors. And Kathryn McGrath, who directed the Division from 1983–90, called attention to the disconnect that occurs when examiners and policymakers interact infrequently. *Id.*

190. See *supra* note 162 and accompanying text.

Company Institute (ICI), the principal trade association for mutual funds and their investment advisers. In particular, the SEC should encourage the ICI to take a more active role in proposing rules to the SEC for possible adoption. The ICI should also be encouraged to increase the number and frequency of the “best practice guidelines” it has developed for members.¹⁹¹

Indeed, whenever new policies and procedures would benefit funds by boosting or restoring public confidence in the industry, the ICI should have very strong incentives to work with the SEC in the development of rules and guidelines for funds and their advisers.¹⁹² Thus, at least in the area of rulemaking and guidance for investment companies and advisers, systematic restructuring of mutual fund regulation is not at all necessary in order to capture several historical advantages of self-regulation.

IV. CONCLUSION

With virtually every other household in the United States invested in mutual funds, effective and efficient regulation of the mutual fund industry must be a top national priority. But the creation of a new private regulator—whether along the lines of SROs such as the NASD and NYSE or the recently created PCAOB—would be a step in the wrong direction. For the reasons set forth in this article, much more can be gained by strengthening the SEC’s longstanding role as the principal overseer of mutual funds and improving other aspects of the existing regulatory regime.

191. In 1999, for example, the ICI created an advisory group on best practices for fund directors. The group issued, and the ICI’s Boards of Governors later endorsed, a report with fifteen policy and procedural recommendations for possible adoption by mutual fund boards. *See* Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999), http://www.ici.org/statements/ppr/arc-pp/rpt_best_practices.pdf. In October 2003, the ICI’s Board of Governors endorsed two additional recommendations to enhance and strengthen the independence and effectiveness of mutual fund boards. *See* Press Release, Investment Company Institute, ICI Board Recommends Two New Governance Standards; Urges Universal Adoption of 17 Best Practices for Mutual Fund Directors, (Oct. 7, 2003), http://www.ici.org/issues/dir/03_news_best_practices.html#. The ICI also developed guidelines for the personal investment activity of fund managers and advisory personnel. *See* Charles A. Fiumefreddo et al., Investment Company Institute, Report of the Advisory Group on Personal Investing (May 9, 1994), *available at* http://www.ici.org/statements/ppr/arc-pp/rpt_personal_investing.pdf.

192. *See* Frankel, *supra* note 8, at 465 n.51 (“The SEC would greatly benefit from the ICI comments on various regulatory issues and from surveys of its members. It is in the interests of the ICI membership to supply such information and have an impact on its regulation.”).